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SENSITIVE

DEPARTMENT FOR EB/OMA AND EUR/SE
TREASURY FOR CPLANTIER

E.O. 12958: N/A
TAGS: ETRD ECON EFIN TU
SUBJECT: CURRENT ACCOUNT CONTINUES TO SWELL

REF: ANKARA 4530

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¶1. (SBU) Summary: Turkey's current account deficit set a new record in June, reaching 2.35 billion USD, for a year-to-date total of 13.7 billion USD and a cumulative total of 19.3 billion USD over the last 12 months. The result slightly exceeded market expectations, but was not a surprise, as Turkey's foreign trade deficit for June (announced earlier this month) had also set a record at 4 billion USD. Istanbul analysts see little difficulty in financing the imbalances in the short term (indeed strong inflows over the first six months of the year enabled the Central Bank of Turkey to build up its reserves significantly), but they warn that the growing imbalance is the key risk factor hanging over the Turkish economy. They also see little prospect for improvement in the near future: exports are beginning to weaken slightly (initial figures show only a 1.1 percent increase in July exports and declines in many categories), and tourism revenues have not met expectations. Most analysts thus predict that this year's current account deficit will reach 5.7 percent or more of GDP, and they expect it to remain over 5 percent next year. End Summary.

¶2. (SBU) A Growing Issue: With exports at 5.8 billion USD and imports of 9.8 billion USD, the 4 billion USD June trade deficit was in line with market expectations, but still highlighted a worrying trend in which the 12-month increase in exports (9.7 percent) has remained below that of imports (16.3 percent). Subsequently, July figures released by the Turkish Chamber of Exporters (TIM) showed exports slowing further, with an increase in July of only 1.1 percent from July 2004. Current account figures released on August 9 also showed a widening gap, with the June deficit at an all time high of 2.35 billion USD, slightly above the market consensus estimate of 2.1 billion. For the first six months of the year, the current account gap grew 38.7 percent to 13.7 billion USD (exceeding the originally projected figure for the year and nearing the current official projection of 15.4 billion USD). The 12-month cumulative deficit also set a record, reaching 19.3 billion USD. Analysts pointed to disappointing tourism receipts as part of the reason for the shortfall: while tourist arrivals increased both in June and in the first six months of the year (26 and 27 percent respectively), tourism income failed to keep pace, rising only 13 percent in June and 16 percent for the six month period. (Note: Turkey's tourism boom has largely centered in cheap package holidays; analysts estimated last week that the average tourist spends only 650 USD in country over the course of a week-long holiday. End Note.) As a result of these trends, most Istanbul analysts see a current account deficit of 5.7 percent or more for the year, with the gap remaining over 5 percent in 2006.

¶3. (SBU) Ready Financing: Though they call attention to the quality of its financing, which has traditionally been through short-term flows of portfolio investment (hot money), analysts see little problem for Turkey in financing the current account gap in the short term. Recent experience supports their view. Financial inflows in the first half of the year totaled 16.9 billion USD (excluding the net errors and omissions discussed below), enabling the Central Bank of Turkey to increase its reserves by some 6.6 billion USD. Portfolio investments grew 50 percent (to 6 billion USD), and financing provided by the banking and non-financial sector also grew, standing at 5.6 billion USD and 5.7 billion USD respectively. In June alone, Turkey had an inflow of 4.9 billion USD. Also indicative is the continued growth in "net errors and omissions", which was 2.7 billion USD in June (5.9 billion USD year-to-date). Most analysts believe this money is "under the mattress" money that has either been parked overseas or otherwise outside the official economy. Some also ascribe part of it to cash coming into the system from border trade, which is typically conducted on a cash-and-carry basis. Whatever the source, it has played a role in supporting the lira, which has reached new heights even as the trade imbalances have swelled. One Central Bank contact told Embassy's Senior Economist that while the bank

does not have an official view, he finds it intriguing that the "net errors and omissions item" has not zeroed itself out over time, as has historically been the case, but instead has been in only one direction since 2003 (into Turkey). In addition to cross border trade (which he reminded us occurs with Iran and Syria as well as Iraq), he suggested it may stem from ineffective accounting for capital inflows into Turkey (since most transactions are accounted for in London). Finally, he said, tourism accounting is also problematic, so that some tourism revenues may be captured through the figure.

¶4. (SBU) A Risk: Despite their perception that the gap can be financed in the short term, Istanbul analysts nonetheless view Turkey's current account deficit as the key risk factor facing Turkey's economy, a view the IMF increasingly shares (reftel). Together with the short terms flows through which it is financed, Baturalp Candemir of EFG Securities sees the gap raising the volatility of the foreign exchange market. He also sees an absence of policy instruments available to the government, given the already high level of Turkey's primary surplus under the IMF program. Only the currency remains as an adjustment tool, he wrote in a recent note to investors. Other observers similarly see the need for a correction in the real exchange rate, given the slowdown in export growth and continued rise in imports. They are not sure this will occur, however, given the continued strong interest of foreigners in Turkish assets. As Candemir told us recently, he has spent the last several months seeking to convince his firms' clients to reduce their Turkish lira exposure, thus far unsuccessfully. Funds have money to place, he commented ruefully, and he said he had underestimated the extent to which Turkey would continue to attract interest even as the local news flow became less positive.

¶5. (SBU) Comment: Most observers here remain confident that the growing current account deficit can be successfully financed. This is based in part on the fact that after a long absence, Turkey finally has the prospect of large flows of FDI. Recent banking deals (Yapi Kredi Bank (in part), Disbank, and TEB were purchased by foreigners) and privatization of a number of state enterprises (including Turk Telecom) should all bring significant foreign capital into the country. It is also predicated on a continued favorable international climate for emerging markets, generally, and on the absence of any Turkish development that sparks investor flight, whether domestic or international. Certainly, investors' threshold for bad news seems to have risen significantly in recent years, and investors have either shrugged it off or seen it as a buying opportunity. Analysts here stress, however, that this underlying complacency is based on Turkey's EU anchor and the October 3 start of negotiations. If serious doubts arise about that, many bets are likely off. The larger problem for the Turkish economy is that continued financing of the deficit through foreign speculative capital will prevent the adjustments in the exchange rate that would help correct it by making exports more competitive and imports more expensive. Turkey's real sector may thus continue to find itself squeezed by a strong lira. End Comment.
SMITH